I.

EXECUTIVE SUMMARY

The City of San Diego [City] is currently facing a deficit of nearly $1.5 billion in the funding of the San Diego City Employees' Retirement System [SDCERS] Retirement Fund. This deficit is an obligation which threatens the fiscal health of San Diego and the future prosperity of all San Diego residents. The deficit arose not only as a result of gross oversight and inattention, but also, unfortunately, by not following the requirements of relevant laws. Below, the nature of the deficit is discussed, its causes, and what the City can do to begin recovering from the crushing debt it has incurred.

II.

OVERVIEW OF THE PENSION CRISIS

A. THE STRUCTURE OF THE PENSION SYSTEM

There are two basic types of pension plans: defined benefit plans and defined contribution plans. Defined benefit plans provide retirees an annual allowance based on years of service and annual earnings. By contrast, defined contribution plans do not specify an annual retirement allowance but rather provide benefits based on employee and employer contributions plus the investment returns earned. Typically, defined contribution plans do not impose a loss in pension benefits for early retirement. As a result, this type of plan will have higher turnover rates as compared to defined benefit plans. The City of San Diego, like many other public entities, has a defined benefit pension plan. The City is obligated to make annual contributions to SDCERS in order to provide a pension for its employees. San Diego City Charter art. IX. Historically, most private and public plans have been defined benefit plans. However, in the last 25 years, there has been a pronounced shift by businesses to defined contribution plans.[1]

SDCERS functions as a trust whose beneficiaries are three classes of employees and former employees with three different types of benefits: general members, safety members and elected officials. The City Council is responsible for determining the level of benefits and required contributions for its members. The trust is administered by the SDCERS Board, not the City Council. The Board has a fiduciary duty to the members to ensure that the plan remains actuarially sound which includes overseeing the proper investment of the assets as well as ensuring the timely payment of retirement benefits. The SDCERS Board retains an actuary to evaluate its assets and liabilities. It is part of the Board's fiduciary duty to approve the methodology and assumptions made by the actuary. Each year the actuary determines the annual amount that must be contributed to the plan in order to cover the plan's annual costs. This annual cost should include both the amount necessary to pay the benefits which accrue in that year (normal cost) as well

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[1] Robert L. Clark, Lee A. Craig, and Jack W. Wilson, *A History of Public Sector Pensions in the United States,* pp. 12–23 (2003).

as the amount necessary to amortize any shortfall between the assets and liabilities (unfunded actuarial accrued liability or "UAAL").

Presently, a member's retirement benefit is calculated by multiplying three factors: the number of years of creditable service, the highest year's salary and the retirement multiplier. The retirement multiplier is a set percentage that is based on age at retirement and class (general, safety or elected). When the multiplier is increased, it has generally been applied retroactively, as it was with the agreements between the City and SDCERS commonly called Manager's Proposal I [MPI] and Manager's Proposal II [MPII], and their associated side benefits, discussed more fully in Part III.A, below. That is, with retroactivity, all employees are entitled to receive an annual retirement allowance based upon this new multiplier for all of their years of creditable service, rather than just those years after the increase. Because the City and employee contributions over the prior years were based upon the previously applicable smaller multipliers, this creates an enormous additional liability.

By way of example, if an employee had worked for the City for twenty-five years, he or she may have begun with a pension multiplier of 1.5% per year or less. Assuming a final salary of $80,000 per year, that would imply a pension benefit of (25 years * 1.5% per year * $80,000), which equates to $30,000 per year for life. However, after the passage of MPI and MPII, the multiplier was changed retroactively to 2.5%. The new benefit would be (25 years * 2.5% per year * $80,000), which equates to $50,000 per year, a $20,000 increase which represents a retroactive 66% raise in retirement pay.

B. PENSION FUNDING

As with any financial plan, the health or viability of SDCERS is determined by the relationship between its assets and liabilities. The assets of the SDCERS system are the funds which have been contributed by the City and the employees plus the return earned on investing those funds. The liabilities of the system are the present value of the estimated future annual benefits owed the beneficiaries. It is important to note that a mathematical "smoothing process" is used in determining the actuarial value of the assets in order to mitigate the effects of dramatic changes in value in the short term. Therefore, when there is a significant downturn in the market as there was in 2001-2003, once these years "roll off" the five year smoothing period, there will be a corresponding increase in the value of the assets. In calculating the liabilities, assumptions must be made about a number of factors such as expected retirement age, mortality rates, projected salary, anticipated employee turnover, disability incidence, and pension fund increases.

The two most popular actuarial funding methods are Projected Unit Cost [PUC] and Entry Age Normal [EAN]. SDCERS utilized the EAN method until 1991 when it switched to the PUC method. The EAN method allocates the total value of a member's expected benefit liability as a level percent of payroll from the age of entry until retirement. The PUC method calculates the actuarial liability for the covered group as a whole, making a number of actuarial assumptions concerning population demographics and returns on system assets. For an individual member, this method allocates the cost as a percent of payroll that typically increases consistently from age of entry until retirement, rather than remaining level as with the EAN method. The EAN method would typically provide a more stable calculation for systems such as SDCERS as cost fluctuations would not necessarily occur due to age fluctuations in the active membership. However, as is discussed below, a decision was made in 1991 to elect the PUC method specifically to reduce City contribution levels in early years after this change.

C. THE PENSION DEFICIT [UAAL]

As of June 30, 2004 (Fiscal Year 2004), SDCERS had $4 billion in actuarial liabilities and $2.63 billion in actuarial assets utilizing the PUC method. The difference is $1.37 billion.[2] This pension deficit is the unfunded actuarial accrued liability [UAAL]. It should be noted that the deficit can continue to grow due to interest accrued on the UAAL. As a result, it becomes even more crucial to reduce the UAAL as soon as possible. The problem is aggravated by the fact that the City has not been paying interest on the UAAL as part of its annual contribution.

The funded ratio is the actuarial value of assets expressed as a percentage of the actuarial liabilities. If SDCERS were 100% funded, the assets would equal the liabilities. As of June 30, 2004 (fiscal year 2004), SDCERS was 65.6% funded. The system was over 90% funded until fiscal year 2001. Significantly, in fiscal year 2002 the funded ratio dipped to 77.3% and then 65.8% in fiscal year 2003 after implementation of MPII.[3] The cumulative financial impact of MPI and MPII as of June 30, 2003 was $467.3 million.[4] This is due to the cost of the retroactive increase in benefits. This benefit increase is reflected in the difference between the median annual allowance of $28,184 for 5,723 retirees as of June 30, 2004 and $44,307 for the 313 new retirees during that year.[5]

D. THE FACTORS GIVING RISE TO THE DEFICIT

There are five factors which have been the primary cause of the $1.37 billion deficit: (1) the City Council created retroactive benefits without increasing the annual contribution to fund them (41%); (2) the SDCERS Board approved the use of inappropriate actuarial assumptions and calculations (31%); (3) the City Council's decision to utilize plan earnings to fulfill other financial obligations (12%); (4) the City Council and SDCERS Board agreeing to a less than full actuarial contribution by the City (embodied in the MPI and MPII agreements) (10%); and (5) the City's annual

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[2] "SDCERS Annual Actuarial Valuation," June 30, 2004, p. 9.

[3] *Id.* at 13.

[4] Letter from Rick Roeder to City of San Diego Pension Reform Committee of 4/20/04.

[5] "SDCERS Annual Actuarial Valuation," June 30, 2004, p. 35.

contribution to the plan not including sufficient funds to pay either the principal or interest on the UAAL.[6] *All five of these* arise out of two primary problems with the management of the plan: creation of benefits without providing a funding source, and intentionally understating the problem with creative accounting.

When the City agreed to increase the annual multiplier rate as it did in 1996 and 2002, this augmented pension benefit was applied retroactively to all members of the affected class of employees, regardless of what they and the City agreed upon when they were hired. This created an immediate cost to the system which today totals almost $500 million for which no funding source was identified.

The second most dramatic cause of the huge pension deficit is the fact that the actuarial assumptions and calculations approved by the SDCERS Board did not comport with reality. The employee turnover was less than forecast and the pay increases exceeded assumptions. In addition there were significant "purchases of service credit" at a rate far less than the costs indicated by the actuary.[7] A purchase of service credit allows an employee to "buy years," thus allowing a 15-year employee, for example, to be treated identically to a 20-year employee for pension purposes, with a corresponding increase in benefits. The use of unrealistic actuarial numbers was not mere inadvertent miscalculation. Rather, it was a deliberate effort by the Board and the City to mask the drain on the plan for the benefit of the City budget. "[T]he City took advantage of certain vagaries of 'actuarial science' and pension accounting to further minimize its contributions to SDCERS." [8]

> The history of the relationship between the City of San Diego and SDCERS plays out as a series of initiatives by the City to reduce (at least in the short term) its contributions to the System, typically in response either to economic conditions that caused budgetary strain or to concessions made to the City's labor organizations. Many of these initiatives have been supported by the labor representatives on the Board. The result in each case was the postponement of difficult budgetary decisions into the future, often exacerbating the problems through the delay in confronting them.[9]

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6 City of San Diego Pension Reform Committee Final Report, September 15, 2004, p. 28.

7 Letter from Rick Roeder to Pension Reform Committee of 5/4/04.

8 Paul S. Maco and Richard C. Sauer, Vinson & Elkins, *Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code*, [Vinson & Elkins Report], September 16, 2004, p. 5.

9 *Id*. at 38.

In order to produce reasonable results, accounting and actuarial methods and assumptions must also be reasonably applied. These can be manipulated to produce misleading results such as "creative accounting."

> Creative accounting involves the selective choice and/or corruption of accounting principles to present a misleading impression. Corruption is accomplished by applying accepted principles in inappropriate circumstances or in an unacceptable or misleading manner. Creative accounting sometimes goes even further and actually involves the structuring and implementing of transactions primarily for the sake of presenting an attractive financial picture with little or no regard for economic reality.[10]

Unfortunately, the SDCERS system has been the subject of open and obviously manipulative pension accounting.

The history of the "creative accounting" began in 1980 when the City began to treat surplus earnings as available to use to reduce its contribution rather than to support the soundness of the system as intended. The City adopted a provision that allocated 50% of SDCERS annual return on its assets which exceeded the actuary's assumed rate of return (defined as "surplus") to be used to fund a 13th check to retirees.[11] This decision to skim off the peaks in earnings not only left the plan without those earnings, but also the corresponding earned rate of return on the funds. By siphoning away these funds, there were no funds available to counterbalance the downturns in the market.

A critical component of achieving stability in a pension system is the assumed rate of return on assets. The greater the investment return, the less the participants must contribute to fund projected benefits. The projected rates of return, like all actuarial assumptions, are not an exact science. Inherent in the analysis is the assumption that over time the fluctuation or variation from the assumptions will average out. The creation of "surplus" earnings flies in the face of this bedrock concept. The reality is that any diversion of earnings from the system--no matter what label is attached to it--creates a liability which will eventually require funding.

SDCERS Retirement System Administrator Lawrence Grissom obviously recognized this and advised the Board in April 2002 "[I] believe there has come a perception over the years that earnings are cash in pocket, which is not the case."[12] This was echoed by SDCERS attorney who opined:

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10 Denzil Y. Causey, Jr., *Duties and Liabilities of Public Accountants* 12 (Rev. ed. 1982).

11 San Diego Ordinance O-15353 (Oct. 6, 1980).

12 SDCERS Board Meeting, Minutes, April 19, 2002, p. 26.

> Defining [s]urplus on a cash basis leads to draining off liquid assets and reducing future earning power. It also undercuts actuarial assumptions about earnings. An assumption of earnings is based on expected averages over a long period of time. By draining off cash in good years, the structure makes it harder to meet the long term earnings assumption.[13]

Use of this "surplus" (in spite of best accounting practices) became a recurring theme as other uses were found for these funds through the years. In 1982 when the City withdrew from the Social Security System, it was required to provide medical benefits. Once again, rather than have this expense be borne by the City budget, the surplus earnings were tapped.[14] This practice continued until this fiscal year. As a result the SDCERS Retirement Fund has been liable for these health care costs. From 1998 to 2000, further uses were found for the surplus earnings, including funding cost of living increase for retirees and to pick up a portion of the employees contributions. These funds were also designated to fund settlement of a lawsuit brought by some SDCERS members who asserted that the Board failed to include all appropriate compensation in determining annual benefits (commonly referred to as the "Corbett" settlement). All of these contingent commitments of surplus earnings are arranged in a hierarchy referred to as the "waterfall."[15]

During 1996 labor negotiations, the City and the Board entered into an agreement with a two-fold disastrous impact. The City granted additional benefits resulting in significant increase in liabilities and SDCERS Board allowed the City to contribute less than the full amount of its annual obligation to the system (MPI). When MPI was entered into in 1996, the plan was more than 90% funded with many years of record earnings exceeding expectations.[16] However, the downturn in the market that began in 2000 resulted in an expectation that the fund ratio floor of 82.3% (a floor put in place by MPI) would be triggered, thus requiring the City to make up the shortfall. In order to avoid this obligation and have the Board agree not to enforce MPI, the City made matters worse by

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13 Letter from Constance M. Hiatt, Hanson Bridget Marcus Vlahos and Rudy ("Hanson Bridgett") to SDCERS, General Counsel Loraine Chapin of 4/16/02.

14 San Diego Ordinance O-15758 (June 1, 1982).

15 San Diego Municipal Code [SDMC] §24.1502.

16 "SDCERS Annual Actuarial Valuation," June 30, 2004, p. 13.

granting more benefits, adding yet further to the plan liabilities (MPII).[17] The fund ratio then dipped to 77.3% in Fiscal Year 2002.[18]

The amortization period for the UAAL was used as another area for "creative accounting." In June, 1991 the 30 year amortization period was restarted from that fiscal year end.[19] This, of course, reduced the City's contribution. Then in 2004, as part of the *Gleason* lawsuit settlement, there was an agreement to restart the amortization period yet again.[20]

Hence, the City has attempted to avoid its financial obligations to SDCERS and its members through "creative accounting" involving readjustment of the amortization period, creation of an artificial "surplus," and cherry-picking calculation methodologies.

In addition, the City began acting like a "credit card junkie" who charges to the card limit and only makes the minimum payments, because the City's annual contributions to the Retirement Fund have not included either the principal or interest on the deficit. The Pension Reform Committee estimated that for the then $1.167 billion UAAL, the additional amount which should have been paid was: $93.3 million in interest on the UAAL, and $33.3 in contingent benefits previously paid from the "surplus" earnings for a total, along with other accrued costs, of $202.67 million. This figure does not include any funds to reduce the UAAL, only to contain it.[21] The City's response: it paid only $85 million of the $202.67 million owed.[22]

The UAAL continued to grow exponentially as the City failed to pay even the purposefully understated amount due and continued to grant additional benefits. It is precisely this lethal combination of underpayment while simultaneously increasing contractually-obligated benefits that put the City in the financial crisis it is in today.

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17 Michael J. Aguirre, San Diego City Attorney, "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials," February 9, 2005, pp. 9 – 17.

18 "SDCERS Annual Actuarial Valuation," June 30, 2004, p. 13.

19 Vinson & Elkins Report, p. 39.

20 Settlement Agreement, in *James F. Gleason, et al. v. San Diego City Employees Retirement System, et al.,* San Diego Superior Court Case No. GIC803779, part II.3(a).

21 City of San Diego Pension Reform Committee, *Final Report*, September 15, 2004, p. 9.

22 *Id*. at 10.

III.

THE FUNDING CRISIS WAS AGGRAVATED BY NOT OBEYING THE REQUIREMENTS OF CALIFORNIA LAW

As discussed above, in 1996 and later in 2002 the City and the Retirement Board took several questionable actions in dealing with the duty to provide sufficient contributions to the Retirement Fund. None of these actions dealt forthrightly with the looming pension crisis, and in fact made the crisis substantially worse. Each time, the City made a deal with the Board--in return for underfunding (providing a contribution rate less than that of a neutral actuary), City workers and Board members would receive enhanced benefits. These actions were not only reckless, but also violated a number provisions of state and local law.

Among the actions that violated provisions of the law are the following: The Retirement Board's decisions to enter into MPI and MPII; the City Council's decisions to enter into MPI and MPII; the City Council's actions in approving resolutions and ordinances to carry out the agreements in MPI and MPII, specifically resolutions R-297212 and R-297335, and ordinances O-19121 and O-19126; the City Council's approval of an amended SDMC section 24.0801, to evade the duty under City Charter section 143 to provide actuarially-determined contribution rates to the Retirement Fund; and the use of a "waterfall" provision (SDMC § 24.1502) to divert funds for purposes unrelated to retirement. These actions violated the California Constitution, state law, the City Charter, and the Municipal code. Below, the specific manner in which each of these actions violated California law is discussed.

A. FACTUAL BACKGROUND AND DEFINITIONS

1. <u>San Diego City Employees Retirement System [SDCERS]</u>

SDCERS is a multi-employer, defined benefit plan established in 1927 by the City to provide retirement benefits to its members. SDCERS operates as a trust under California law. Cal. Const. art. XVI, § 17; City Charter art. IX, § 145. The City is the plan sponsor. There is no "trust" document beyond the Municipal Code sections that discuss the SDCERS fund. *See* Municipal Code, §§ 24.0100 *et seq.*

SDCERS is governed by three main sources of law: the California Constitution, art. XVI, § 17; the San Diego City Charter, art. IX, §§ 141 through 148.1, and art. X, §1; and the Municipal Code, §§ 24.0100 *et seq.* Board members have a constitutional duty to act in furtherance of three main goals: providing benefits to plan members; keeping employer contributions low; and minimizing the cost of system operations. The SDCERS Board's duty to its participants "shall take precedence over any other duty." Cal. Const. art. XVI, § 17.

2. <u>Manager's Proposal I [MPI]</u>

In the spring of 1996, the City conducted negotiations with its labor unions for the terms of the City's labor contracts. Through the "meet and confer" process, the City granted several new retirement benefits to the unions. Among these benefits were, most notably: 1) significant increases in the formula for calculating the basic pension benefit, including an increase in the year multiplier from 1.45% to 2.00% for general city employees; 2) the agreement of the City to implement the so-called Deferred Retirement Option Plan [DROP], by which employees could "double-dip" by banking retirement payments before they were actually retired, and receive a guaranteed interest rate on those payments for life; and 3) an expansion of the "purchase of service credit" under which employees could buy "air time" and be treated, for retirement purposes, as having worked more years than he or she actually had worked.

The granting of these new benefits was conditioned on the agreement of the SDCERS Board to an "Employer Contribution Rate Stabilization Plan" (commonly referred to as Manager's Proposal I, or "MPI"), an agreement required by the City Manager. This was in spite of the fact that the Board's fiduciary duties logically had nothing to do with the meet and confer process between the labor unions and the City.

By MPI's terms, rather than contribute to the Retirement Fund the legally-required amount calculated by an actuary, the City made contributions to SDCERS based on an artificial, negotiated rate. Using the non-actuarial rate, the City's annual contribution for fiscal year 1996 would remain at the prior year's rate of 7.08. In the next year, 1997, the rate would be 7.33 percent. In following years, the City's annual contribution would increase by .5 percent each year until the City reached an Entry Age Normal [EAN] contribution rate, which would be closer to an actuarially-established rate. This transition period was to take ten years, ending in 2008. At that point, the City would agree to use an actuarially-based rate in all future years.

In addition, MPI added a "trigger" provision, set at 82.3 percent. If the funded ratio of the Retirement Fund dropped below 82.3 percent, the City contribution rate would be increased to an "amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10 percent below the funded ratio calculated at the June 30, 1996 actuarial valuation." Notably, there was disagreement as to what this provision meant. Using one interpretation, if the trigger were hit, the City would restore the funded ratio to the 82.3 percent level by making a lump-sum payment. Using another interpretation, the City would pay at a full Projected Unit Credit [PUC] rate in the following fiscal year. Regardless of the interpretation, MPI was designed to avoid having to pay an actuarially-determined rate and to push debt onto future fiscal years.

3. <u>Manager's Proposal II [MPII]</u>

The public financial markets began declining significantly in the spring of 2000. This decline took a severe toll on the asset base and financial status of SDCERS as well as other public pension funds. This decline, combined with the extraordinary benefits granted under MPI and the related agreements described above sent the SDCERS funded ratio into a freefall. By fall 2001, the 82.5% trigger had almost been reached. As the spring of 2002 approached, the City was involved in labor negotiations with four of the City's municipal labor unions. As before, the City viewed the labor negotiations, although not logically tied to the duties of the SDCERS Board, as a way to extract financial concessions from the Board.

In the meet and confer process with the labor unions, in order to yet again avoid paying an actuarially-determined contribution rate to the Retirement Fund, the City agreed to increase retirement benefits to an even greater degree than MPI had done. However, those increased benefits were explicitly contingent upon the SDCERS Board agreeing to a low contribution rate from the City. The proposed agreement between the City and SDCERS Board was reduced to writing in a document entitled "Agreement Regarding Employer Contributions Between the City of San Diego and the San Diego City Employees' Retirement System," commonly referred to as Manager's Proposal II [MPII].

Negotiations began with the City asking the Board to reduce the trigger 82.3 percent to 75 percent. In addition, the City wanted five years to increase payments to a full actuarial rate. The SDCERS actuary and outside fiduciary counsel both recommended against this first version of MPII. After further negotiation, the MPII agreement approved by the Board retained the existing 82.3 percent trigger. However, the City could keep paying so-called "contract rates," rather than the legally-required rates calculated by an actuary. The City agreed to increase its contribution rates 1.0% per year until 2008. MPII would then terminate in 2009.

The SDCERS' actuary observed that the Retirement Fund would be in better financial shape if the contributions were based on actuarial considerations. The actuary specifically noted that it would be preferable not to deviate from MPI:

> From a pure actuarial viewpoint, it would be best to hold the City to the existing Managers Proposal [MPI] and the 82.3% trigger….[f]rom a pure actuarial viewpoint, we would prefer it if the Board <u>did not</u> provide a transition period to the City to reach the [full actuarial rate].[23]

SDCERS' outside counsel also agreed with the assessment of the actuary, and warned at one point that a court could find that the Board was not exercising its fiduciary responsibilities, and could find individual Board members liable for their actions.[24]

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[23] Letter from SDCERS Actuary Rick Roeder to SDCERS Board, November 5, 2002; see also Vinson & Elkins Report, pp.82-86 (emphasis added).

[24] *See* Letter from SDCERS' counsel Robert Blum to Lawrence Grissom, SDCERS Plan Administrator, June 2002 (draft).

Despite these direct warnings, the SDCERS Board and the City entered into MPII pursuant to a written and signed agreement approved by the City Council on November 18, 2002. In furtherance of that agreement, the City passed several resolutions and ordinances, specifically resolutions R-297212 and R-297335, and ordinances O-19121 and O-19126. The City also amended Municipal Code section 24.0801 so that the City would not be required to make contributions to the Retirement Fund as determined by an actuary (a requirement of §143 of the City Charter).

These resolutions and ordinances passed by the City Council were the "payback" in return for the Board's agreement to permit underfunding of the pension under MPII. The most egregious benefits granted by the Council under this new "quid pro quo" were: (1) another increase in the "retirement factor" from 2.0% to 2.5% for general members, and as before, retroactive through all years of service; (2) an exception from the 90% "retirement allowance cap" for employees who joined the City before their 24th birthday, which would directly benefit one Board member financially; (3) a so-called "Presidential Benefit" whereby presidents of the City's four recognized labor unions could have their salaries earned while serving as union presidents counted as though they were City salaries for the purposes of retirement; and (4) a City Council resolution (R-297335) specifically indemnifying the Board members for taking these actions. Again, as before with MPI, the City induced the Board to abandon its logical and fiduciary duties, and made the delivery of these new benefits contingent upon the Board's adoption of an inadequate contribution rate.[25] The payment avoidance scheme of 1996 was therefore repeated in 2002, with today's nearly $1.5 billion funding deficit being the predictable and disastrous result.

B. SPECIFIC VIOLATIONS OF LAW

1. Violations of the California Government Code

California Government Code section 1090 [section 1090] precludes a public officer or city employee from participating in the making of a contract in which he or she has a "financial interest." It provides in pertinent part: "Members of the Legislature, state, county, district, judicial district, and city officers or employees shall not be financially interested in any contract made by them in their official capacity, or by any body or board of which they are members." Cal. Gov't Code §1090. Although the term "financial interest" is not specifically defined in the statute, an examination of the case law and the statutory exceptions to the basic prohibition indicates that the term is to be liberally construed. *Thomson v. Call*, 38 Cal. 3d. 633, 645 (1985).

A public officer cannot escape liability for a section 1090 violation merely by abstaining from voting or participating in discussions or negotiations. Mere membership alone on the board or council establishes the presumption that the officer participated in the forbidden transaction or influenced other members. *Id.*

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[25] Vinson & Elkins Report, pp.80-81.

As the Supreme Court has explained:

> The statute is . . . directed not only at dishonor, but also at conduct that tempts dishonor. This broad proscription embodies a recognition of the fact that an impairment of impartial judgment can occur in even the most well-meaning men when their personal economic interests are affected by the business they transact on behalf of the Government. To this extent, therefore, *the statute is more concerned with what might have happened in a given situation than with what actually happened.* It attempts to prevent honest government agents from succumbing to temptation by making it illegal for them to enter into relationships which are fraught with temptation.

Stigall v. City of Taft, 58 Cal. 2d 565, 570 (1962) quoting *United States v. Mississippi Valley Generating Co.,* 364 U.S. 520, 549-50 (1961).

The purpose of the law goes beyond addressing actual fraud or dishonest conduct associated with contracting, and is intended to "remove or limit the *possibility* of any personal influence, either directly or indirectly, which might bear on an official's decision." *Finnegan v. Schrader,* 91 Cal. App. 4th 572, 579-80 (2001) quoting *Stigall*, 58 Cal. 2d at 569. It is aimed at eliminating temptation, avoiding the appearance of impropriety, and assuring the government of undivided and uncompromised allegiance from its officials. *People v. Honig,* 48 Cal. App. 4th 289, 314 (1996). Hence, it has received a broad judicial interpretation consistent with the Legislature's broad intent. *Id.* at 314. The forbidden interests covered by the rule extend to expectations of benefit by express *or implied* agreement and may be inferred from the circumstances. *Id*. at 315.

In the case of the SDCERS Board, no less than six trustees had a prohibited financial interest in MPII and the related side agreements, namely Ron Saathoff, Mary Vattimo, Cathy Lexin, Terri Webster, John Torres and Sharon Wilkinson, who were all City employees. Section 1090 would therefore prohibit their participation in the multi-party deal to enhance benefits and underfund the pension. Even if they had recused themselves, which they did not, the law would deem them to have participated: "the element of participation is present by the mere fact of . . . membership irrespective of whether the employee or officer personally abstains from engaging in any of the embodiments resulting in the making of the contract." *Fraser-Yamor Agency, Inc. v. County of Del Norte,* 68 Cal. App. 3d 201, 211 (1977). Any contract entered into in violation of section 1090 is void as a matter of law (*Thomson v. Call*, 38 Cal. 3d 633, 646 (1985)), and therefore both the Board's and the City's actions in furtherance of the illegal scheme were void *ab initio* and of no effect.

No defense can be successfully raised that the pension benefits are analogous to "salaries," and therefore exempt. If they were considered salaries, they would not necessarily be considered a financial interest causing a conflict of interest under the Political Reform Act (PRA). However, the *Honig* court rejected the argument that suggests that the legislature intended the definition of a "financial interest" in the PRA to control Section 1090. *Honig,* 48 Cal. App. 4th at 328. The court explained that under well-settled rules of statutory construction, the more general provisions of the PRA do not control the more specific terms of section 1090. *Id.* at 329. Therefore, the "salary" defense will almost certainly not apply here. Furthermore, even if these pension benefits were *hypothetically* considered to be salaries, and therefore a "remote interest" under Government Code section 1091(b)(13), MPII and the related side agreements would still be void because not one of the six financially-involved individuals disclosed his or her interest or followed the other steps required by section 1091(a):

> An officer shall not be deemed to be interested in a contract entered into by a . . . board of which the officer is a member . . . if the officer has only a remote interest in the contract and if the fact of that interest is disclosed to the body or board . . . and noted in its official records, and thereafter the body or board authorizes, approves, or ratifies the contract in good faith by a vote of its membership sufficient for the purpose without counting the vote or votes of the officer or member with the remote interest.[26]

No member of the Board followed the duties outlined above, and thus the "salary exception" cannot prevail when considering the Board's actions.

Under section 1090 analysis, the intentional underfunding (through MPI and MPII) and the related side deals were a single transaction, with each contingent upon the other. This principle of considering all related transactions and acts together as part of one whole is embodied in the case of *Thomson v. Call,* 38 Cal. 3d 633 (1985). In that case, Call, a councilman of the City of Albany, sold his real property to the city, using a developer, IGC, as a conduit. The city entered into a contract with IGC in which IGC agreed to obtain land and convey it to the city for use as a park, or failing to acquire the land, to convey up to $600,000 to the city to acquire the land through eminent domain proceedings. Then, instead of Call selling land directly to the city, IGC purchased Call's land for $258,000 and conveyed it to the city through a second transaction.

The California Supreme Court analyzed the situation and held that IGC's purchase of property from the Calls, and its conveyance of that property to the city, were a single multi-party agreement. *Id.* at 644. Call contended that the purchase of his property was not a term or condition of the contract between IGC and the city, but rather, was a separate contract between IGC and the city. In rejecting that argument, the Supreme Court reasoned that "the prospect that performance of the contract would involve acquisition of the Calls' land and conveyance of that land to the city was contemplated by all parties. . . . Purchase of the Calls' parcel was clearly part of a previous arrangement; the fact that the real estate purchase contract between the Calls and IGC was entered into after the city's acceptance of [IGC's] $600,000 plan in no way alters the fact that the transactions between the Calls, IGC, and the city were part of a single agreement." *Id.* at 644-45. "As part of the transaction at issue, Call sold property to the city, using IGC as a conduit. Whether we regard his interest as direct or indirect, it is

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[26] Cal. Gov't Code §1091(a).

clearly a pecuniary interest forbidden by section 1090 and by the decisions applying conflict-of-interest rules generally." *Id.* at 646.

In this instance, there is clearly one multi-party agreement even though MPI and MPII were agreements between the City and SDCERS, and the "quid pro quo" benefit enhancements arose from negotiations between the City and its labor unions. As in the *Call* case, all parties knew that the benefit enhancements were contingent upon a lower contribution rate from the City to the Retirement Fund. In fact, one of the individuals most involved in the negotiation of the benefit enhancements between City and the labor unions (Cathy Lexin), was also a SDCERS Board member who voted in favor of MPII. Ron Saathoff, similarly, was intimately involved in the negotiation of the benefit enhancements on behalf of Local 145 and on behalf of himself for the notorious "Presidential Benefit," while simultaneously a member of the SDCERS Board that voted on MPII. Simply put, it was impossible for the SDCERS Board members to exercise "absolute loyalty and undivided allegiance to the best interests of the city." *Stigall,* 58 Cal. 2d at 569. All of the contribution rate reductions and benefit enhancements were carried out in a manner contrary to law, and are therefore void.

2. Political Reform Act of 1974 Violated

The Political Reform Act of 1974 [PRA] prohibits a public official from participating in the negotiation, discussion or vote on any contract in which the public official has a financial interest. The PRA is codified as Cal. Gov't Code §§ 81000 *et seq*. The purpose of the PRA is to prevent a government official from participating in a decision where the official has a financial interest which might be materially affected by his or her action on the matter. *County of Nevada v. MacMillen*, 11 Cal. 3d 662, 668 (1974).

The PRA provides as follows:

> No public official at any level of state or local government shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest.[27]

The law gives additional guidance on what constitutes a disqualifying interest and what happens if an official action is taken despite that interest. Under Government Code section 87103, "[a]n official has a financial interest in a decision…if it is reasonably foreseeable that the decision will have a material financial effect, distinguishable from its effect on the public generally, on the official [or] a member of his or her immediate family . . . ." If the PRA is then violated, "[a] court may set the official action aside as void." Cal. Gov't Code § 91003. Contracts such as MPI and MPII are the type of "official action" that may be set aside as void under the PRA. *Affordable Housing Alliance v. Feinstein*, 179 Cal. App. 3d 484 (1986).

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[27] Cal. Gov't Code § 87100.

The PRA applies here because certain board members participated in decisions in which a board member had a financial interest within the meaning of the statute. Here, for both MPI and MPII, there are two agreements at issue — (i) the agreement by the City to provide enhanced benefits as a result of the City's meet and confer process with its labor unions, and (ii) the agreements to underfund the system in MPI and MPII.

Here, the City's labor negotiators and not the SDCERS Board negotiated and entered into the labor agreements that resulted in enhanced benefits. The SDCERS Board should not have negotiated or approved the enhanced benefits, nor could it properly do so under its grant of power. The labor negotiations and collective bargaining agreements were a City responsibility. Therefore, no Board member (in their role as a member of the Board) should have participated in or entered into an express or implied contract with the labor unions or the City for any improvement in benefits.

For the reasons highlighted above, the benefit enhancements negotiated in the spring of 1996 and the spring of 2002 were contingent upon the Board's approval of MPI and MPII. As such, they must be treated as a single, multiparty transaction under the PRA.

In undertaking a PRA analysis, the first question to be addressed is if increased pension benefits do indeed constitute a "financial interest." Based on the "public salary exception" an argument can be made that increased pension benefits are normally not a "financial interest" under the PRA. In 1977, the Fair Political Practice Commission [FPPC] found that under the PRA a board member's participation in a decision that could affect that member's pension benefits was not a disqualifying financial interest. In addition, in 2002 the FPPC reasoned that pension benefits from a governmental agency are not a "financial interest" within the meaning of the PRA.

Following the above reasoning, if a voting body or council makes ordinary salary or pension adjustments, they might not be in violation of the PRA. However, it should be kept in mind that although the SDCERS' Board members duty was to discuss and vote on MPI and MPII, the Board's approval of MPI and MPII was the deciding factor in whether the City would provide enhanced benefits. Due to the nature of this scheme, the salary exception may not apply here. In that case, the PRA analysis proceeds to examine whether the benefits were "distinguishable from [their] effect on the public generally." Cal. Gov't Code § 87103. Government Code Section 87103 provides in relevant part that, "A public official has a financial interest in a decision … if it is reasonably foreseeable that the decision will have a material financial effect, distinguishable from its effect on the public generally." Under the PRA, the language "the public generally" may be interpreted to mean members of a particular trade, industry, or profession, if the agency is required or expressly authorized by law to draw its members from the particular trade, industry or profession. *Consumer Union of U.S., Inc. v. California Milk Producer*, 82 Cal.App. 3d 433, 436-438 (1978); Cal. Gov't Code § 87103.

When the non-actuarial reductions to the City's contribution rate were being considered, the SDCERS Board was required to have a number of city employees as members. Therefore, it can be argued that a material financial interest would not exist under the PRA because the financial interest felt by the general members of the Board would be equally felt by a large number of other City employees.

However, other pension and benefit actions taken in this situation were anything but ordinary, and did not affect a large group. As to the "Presidential Benefit" that allowed the four labor union presidents to include their union salaries as part of their highest annual compensation for calculating the retirement allowance, only four people were affected, one of which is Board member Ron Saathoff. In addition, Board member Terri Webster (the Assistant City Auditor) received a personal benefit similarly available only to a small group of people, namely, not being held to the 90% retirement cap because she began working for the City before the age of twenty-four. Finally, beyond these two members, all the Board members were granted special indemnity by the City Council in resolution R-297335, a benefit designed for that group only. Although the PRA has a "public salary exception," that exception was not designed to cover to the egregious and flagrant self-dealing seen here and would not likely apply. Taken as a whole, the PRA was not followed, and the actions taken in contravention of that law are void or voidable.

3. Violations of the California Constitution

In agreeing to forgo the proper payments to the Retirement Fund, the SDCERS Board and the City violated not only California's conflict of interest laws, but also the bedrock principles of the California Constitution. Below, three violations of the Constitution are discussed: (1) the abandonment of the Board's fiduciary duties (Cal. Const. art. XVI, §17); (2) the prohibition against incurring indebtedness without a vote of the people (Cal. Const. art. XVI, §18); and (3) the constitutional right of public employees to a fiscally-sound retirement system. The violation of any one of these Constitutional rules, much less all three, would render the payment-evasion scheme of the Council and SDCERS Board null and void. The violations were patent and intentional, and therefore the underfunding scheme and its associated side benefits should have no further force or effect.

The first important principle that was violated is the fiduciary duty of the Board to retirees and future retirees, embodied in article XVI, section 17 of the California Constitution. It reads, in pertinent part:

> Notwithstanding any other provisions of law or this Constitution to the contrary, the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system, subject to . . . the following: . . . (c) The members of the retirement board . . . shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries. . . .

> A retirement board's duty to its participants and their beneficiaries *shall take precedence over any other duty*.

Cal. Const. art. XVI, §17 (emphasis added). As discussed in the case of *Westly v. CALPERS Board of Administration*, 105 Cal. App. 4th 1095 (2003), Article XVI, section 17 was enacted primarily to give pension boards independence so their funds would not be "raided" by legislative bodies. *Id*. at 1111. However, the authority of the board is to be used for "the <u>protection</u> of the . . . assets, benefits, and services for which the [b]oard has a fiduciary responsibility." *Id*. at 1110 (emphasis added).

However, when the board goes beyond its legal mandate, it has no authority. *Westly*, 105 Cal. App. 4th at 1099-1100; *see also In re Retirement Cases*, 110 Cal. App. 4th 426, 471 (2003). Considering the actions of the SDCERS Board, the inevitable conclusion is that the Board improperly considered the ongoing labor union "meet and confer" negotiations when considering the contribution rates under MPI and MPII. And the City improperly influenced the Board by "sweetening the deal," including granting special benefits for specific Board members (Saathoff and Webster), and specifically indemnifying the whole Board for their actions. The Board's desire for such indemnity is understandable, considering that their actions directly violated their constitutional duties.

Another key California constitutional principle is the idea that no debt can be imposed on the citizens of a city without a vote. This provision was violated as well. Article XVI, section 18 of the California Constitution states in relevant part, "No . . . city . . . shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose."

The adoption of MPI and MPII in 1996 and 2002 by the City Council which allowed for the under-funded status of the City's Retirement system created a long-term indebtedness for the City that exceeded the income and revenue necessary to sustain the indebtedness on a yearly basis. By agreeing to under-fund the plan on a yearly basis and using the surplus and earnings to provide for increased benefits, the City was incurring a real debt that it did not have sufficient funds to support. According to the Constitution, the only way the City could have legally created such a financial liability was through a citywide election. This did not occur. Therefore, the ordinances that allowed for such under-funding and possibly the increased benefits that such under-funding made possible were in violation of the Constitution and are void as a matter of law.

Finally, in addition to the protections of article XVI, sections 17 and 18 of the California Constitution as discussed above, public employees have a constitutionally-protected contract right to a financially sound retirement system. *Board of Administration v. Wilson,* 52 Cal. App. 4th 1109, 1131, 1135 (1997); *Valdes v. Cory,* 139 Cal. App. 3d 773, 783-84 (1983); *Betts v. Board of Administration,* 21 Cal. 3d 859, 863 (1978). This right was violated when the "quid pro quo" of MPI and MPII were carried out which deliberately underfunded the SDCERS pension plan.

In *Wilson,* the California legislature attempted to modify the funding of the California Public Employees' Retirement Fund [PERS]. In an effort to balance the state's budget by shortchanging the PERS fund, between 1991 and 1993 the California legislature changed the payment schedule for funding PERS to an "in arrears" financing system and in doing so moved away from a "level contribution" system that paid for pension liabilities as they accrued. *Wilson,* 52 Cal.App.4th at 1117-1122. The court in *Wilson* held that such a financing scheme, which delayed funding of the retirement system to balance the state's budget, was in effect an impairment of the employees' vested contract rights. *Id.* at 1144.

The court in *Wilson* also determined that the California Constitution protects the public employees' right to an actuarially sound retirement system. *Wilson,* 52 Cal.App.4th at 1135. Whether or not a pension fund is "actuarially sound" is a question of fact. *Id.* at 1139. Here, MPI and MPII depart from the principles of level cost financing because current liabilities are shifted to later years. Under their non-actuarial contribution methods, SDCERS funding ratio had plummeted to 65.8% percent by June 30, 2004. Only two years earlier, on June 30, 2002, the system had a funded ratio of 77.3%. This precipitous drop represented a severe threat to the fiscal health of the Retirement Fund. As this decline in the funded ratio was a result of deliberate underfunding as part of a scheme between the City and the Board, it therefore violates the constitutional rights of the employees of the City of San Diego.

A final *Wilson* violation can be found in the use of so-called "surplus earnings" to pay benefits outside of the SDCERS retirement plan violates the principles of actuarial science. This technique is codified in the "waterfall" provision of section 24.1502 of the SDMC. Through the waterfall, funds earmarked for retirement are diverted into uses unrelated to retirement such as health care benefits. As discussed above, public retirement system beneficiaries are entitled to an actuarially-sound system. Thus, the waterfall provision, SDMC section 24.1502, violates the constitutional requirements of *Wilson* and is also void.

4. San Diego City Charter Violated

The San Diego City Charter provides the City with clear guidelines as to the creation and funding of future City debt and the manner in which the City is obligated to contribute to the retirement system. It has been firmly established by California case law that a City Charter represents the "supreme law of the City, subject only to conflicting provisions in the federal and state Constitutions and preemptive state law." *Domar Electric, Inc. v. City of Los Angeles,* 9 Cal. 4th 161, 170 (1994). The charter operates as an "instrument of limitation and restriction on the exercise of power over all municipal affairs which the city is assumed to possess." *Id*. The California Supreme Court held in the *Domar* case that a charter city may not act in conflict with its charter and that *any act* that is not in compliance with the city charter is void. *Id*. at 171 (emphasis added).

Below, three violations of the Charter are discussed: (1) the creation of long-term indebtedness for the City that exceeded the income and revenue necessary to sustain the debt on a yearly basis (Charter Section 99); (2) the City's intentional deviation from actuarially computed retirement system contribution rates in favor of "negotiated" rates--an action that the City attempted to legitimize by formally manipulating the Municipal Code and which violated Charter Section 143; and (3) the creation of benefits without a corresponding funding source (Charter Section 39). Similar to the violations of the California Constitution outlined above, these Charter violations render the underfunding scheme and its associated side benefits void and without further force or effect.

San Diego City Charter section 99 mirrors the language of California Constitution article XVI, section 18, discussed above, regarding public finance. City Charter Section 99 provides:

> The City shall not incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year unless the qualified electors of the City, voting at an election to be held for that purpose, have indicated their assent as then required by the Constitution of the State of California, nor unless before or at the time of incurring such indebtedness provision shall be made for the collection of an annual tax sufficient to pay the interest on such indebtedness as it falls due, and also provision to constitute a sinking fund for the payment of the principal thereof, on or before maturity, which shall not exceed forty years from the time of contracting the same…

City Charter Section 99 further states:

> No contract, agreement or obligation extending for a period of more than five years may be authorized except by ordinance adopted by a two-thirds' majority vote of the members elected to Council after holding a public hearing which has been duly noticed in the official City newspaper at least ten days in advance.

As stated above, the adoption of MPI and MPII in 1996 and 2002 by the City Council which allowed for the under-funded status of the City's Retirement system created a long-term indebtedness for the City that exceeded the income and revenue necessary to sustain that debt. Without the requisite vote, by incurring a real debt that the City did not have sufficient funds to support the City violated Charter Section 99. As such, the ordinances that allowed for such underfunding and the related side benefits were in violation of the City Charter. By doing that which the Charter expressly prohibits, the City took action which exceeded its power such that the action is void as a matter of law.

Beyond the vote requirement of Charter section 99, San Diego Charter section 143 imposes a duty to use actuarially-based contribution rates. Charter section 143 states, in relevant part:

> The mortality, service, experience or other table *calculated by the actuary and the valuation determined by him* and approved by the board shall be conclusive and final, and any retirement system established under this article shall be based thereon… (emphasis added.)

This Charter section mandates that the City's contributions to the system must be based on rates computed by the system's actuary and not based on rates otherwise negotiated between the City and the Board. The clear text of the Charter evidences the fundamental need to maintain an actuarially sound system. Notwithstanding this, the City, by way of MPI and MPII, created an unlawful funding strategy based on negotiation with the Board, and not based on actuarial science. Furthermore, prior to November 18, 2002, SDMC section 24.0801, which was consistent with Charter section 143, prohibited the City from deviating from the Board's actuaries computed contribution rate.

As such, on November 18, 2002, the City simply went beyond its power by amending SDMC section 24.0801 so that it permitted their funding scheme but conflicted with the Charter. The amended section stated that the City's contribution would be "amounts agreed to in the governing Memorandum of Understanding between the City and the Board." While this change may have allowed the City to adopt funding mechanisms not based on actuarial science, those funding mechanisms continued to violate the Charter. Further, this illegal SDMC change evidences an attempt by the City to legitimize the underfunding mechanisms created by MP I and MPII.

In addition to the violations of Charter sections 99 and 144 described above, Charter section 39 was also violated by the City's failure to provide funding sources for the aforementioned benefits. In relevant part, City Charter section 39 provides: "No contract, agreement, or other obligation for the expenditure of public funds shall be entered into by any officer of the City and no such contract shall be valid unless the Auditor and Comptroller shall certify in writing that there has been made an appropriation to cover the expenditure and that there remains a sufficient balance to meet the demand thereof." By approving the MPI and MPII ordinances and associated side deals, the City acted in violation of the requirements provided in Section 39 in that no written certification was made regarding the appropriations for the real costs to the City of MPI, MPII and the related side deals.

5. <u>San Diego Municipal Code Disobeyed</u>

Beyond the violations of California conflict of interest laws, the Constitution, and the City Charter, the SDMC itself was also not followed. First, as discussed above, before the City Council modified SDMC section 24.0801, it required the City to contribute to the Retirement Fund and amount "as determined by the System's actuary pursuant to the annual actuarial evaluation." Former SDMC section 24.0801 (prior to Nov. 18, 2002). Thus, the City's actions were not in compliance with this provision from the 1996 inception of MPI to the change in the SDMC in 2002.

Second, San Diego's local conflict-of-interest rules were violated as well. SDMC section 27.3560 prohibits City officials from participating in any contract made by them when that official has a "financial interest" in the subject of the contract. Section 27.3560 prohibits the type of activity described in Government Code section 1090 discussed above. Municipal Code section 27.3560 states:

> (a) It is unlawful for any City Official to be financially interested in any contract made by them in their official capacity.
>
> (b) It is unlawful for any contract to be made by the City Council *or any board or commission established by the City Council* if any individual member of the body has a financial interest in the contract.[28]

As discussed earlier with regard to Government Code section 1090, in the case of the SDCERS Board no less than six trustees had a prohibited financial interest in MPII and the related side agreements, namely Ron Saathoff, Mary Vattimo, Cathy Lexin, Terri Webster, John Torres and Shannon Wilkinson, who were all City employees. SDMC section 27.3560 would therefore prohibit their participation in the multi-party deal to enhance benefits and underfund the pension. Further, as highlighted above, at least two Board members, Ron Saathoff and Terri Webster were granted exclusive benefit enhancements that offered them a financial subsidy that clearly did not reach to the members of the system at large. And the whole Board was given indemnity for their participation in the scheme. These actions did not comply with the requirements of the SDMC.

IV.

LEGAL AND FINANCIAL CONCLUSIONS

The City Council induced the SDCERS Board to violate its fiduciary duties to its retirees by enticing the Board with special benefits. Unfortunately, the Board responded to this pressure and allowed the City to underfund the pension from 1996 to the present day. This unchecked abuse not only violated state law, the California Constitution, the San Diego City Charter and the SDMC, but also caused the collapse of the fiscal health of Retirement Fund, now running an approximately $1.5 billion deficit. All of the following agreements and actions--MPI and MPII, designed to shortchange the Retirement Fund; Resolutions R-297212 and R-297335, and Ordinances O-19121 and O-19126, the "side deals" of MPII; SDMC section 24.0801, enacted to evade City Charter section 143; the "waterfall" of SDMC section 24.1502, which diverts funds for purposes unrelated to retirement; the DROP program; the buying of cheap "air time" below market rates; the notorious "Presidential Benefits"; and other inducements and unearned benefits are all void as they blatantly violated legal requirements, fiduciary duties, and the trust of the public, and in fact were void from their inception.

In recognition of this, the City has, within the last year (July 7th, 2004), entered into a legal settlement under which it has agreed to no longer use the artificially low

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[28] SDMC §27.3560 (emphasis added).

contribution rates of MPI and MPII, and to rework SDMC section 24.0801 to conform with the Charter.[29] This is a good first step, but the City continues to provide the "quid pro quo" benefits that were part of the unlawful scheme. These continued benefits were void, and the City should cease observing the terms of these agreements.

On an ongoing basis, the options available to solve the pension deficit are: increase plan assets, decrease plan liabilities or a combination of both. There are financial limitations on increasing assets and other legal limitations on reducing liabilities. However, if these hurdles are not overcome the only option remaining is bankruptcy.

There are only two potential sources of funds for the City to increase SDCERS assets: (1) revenues in the current budget; and (2) additional new revenues, i.e., taxes. This of course translates into an additional expense for the citizens of San Diego. Given the magnitude of the deficit, it is not realistic to believe that taxes or budget cuts alone can solve the problem in the near term.

Therefore, liabilities must be reduced. This means previously granted employee benefits must be changed. There are limitations in doing so. Benefits can only be changed through labor negotiations or a Chapter 9 reorganization. If labor negotiations are to be successful, it must be recognized that the employees unions will not agree to bear the entire burden of the City's failure to fund previously negotiated benefits. Hence, the necessity to develop a "share the pain" plan that provides for parity among those impacted. That is, both City employees and taxpayers must contribute to resolution of the problem. If the "share the pain" plan is not pursued promptly and diligently, the only remaining solution is a Chapter 9 proceeding.

As discussed above, and as is true with any debt, the sooner the approximately $1.5 billion deficit is paid off, the less it will cost. However, two things must be kept in mind: (1) it is unrealistic to expect to reverse the damage incurred over several years in a single year; and (2) a plan funded at 90% is considered healthy. If the plan were to be funded at 90% in one year, that is $1.058 billion as of July 1, 2005. If the goal was to fund it at 90% over two years, $529 million would be required each year and if it were amortized over three years, $353 million annually is needed.[30] There are a number of sources of revenues and a number of options available to reduce benefits. The most equitable plan would be to have the employees and the taxpayers share responsibility for the deficit equally with half of the funds obtained through liability reduction and half through an increase in assets.

In order to avoid bankruptcy, the Mayor and Council need to: (1) determine the time period for repayment; (2) designate the source of additional revenues and budget cuts to fund 50% of the resulting annual obligation; (3) allow the labor unions to select among the benefit reduction options to achieve their 50% obligation; (4) enact legally

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[29] Settlement Agreement, in *James F. Gleason, et al. v. San Diego City Employees Retirement System, et al.,* San Diego Superior Court Case No. GIC803779, part II(b)-(c).

[30] Letter from Rick Roeder to Deborah Berger and Bruce Herring of 2/4/05.

binding mechanisms to ensure that each of these three essential elements are accomplished; and (5) establish oversight procedures to ensure that the plan is adequately funded in the future.

The City Attorney's Office also encourages the Mayor and City Council to adopt new municipal ordinances which would require the Board to operate within the standards of the Employee Retirement Income Security Act [ERISA]. Changing our municipal law in this manner would better serve the present and future retirees by making the financial footing of the Board more secure. The City Attorney's Office will, at a later date, present the Mayor and City Council with an ERISA-compliant proposal fashioned to fit San Diego's circumstances.

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